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February 14, 2006

AGENDA ITEM 7a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Credit Enhancement Program – Annual Review

II. PROGRAM: Credit Enhancement Program (CEP)

III. RECOMMENDATION: Information Item – Annual Review

IV. ANALYSIS:

Background:

- At the February 18, 2003 Investment Committee meeting, the Board approved the nationwide Credit Enhancement Program (CEP) with an initial commitment of $5 billion.
- September 2003: The Investment Committee approved the Policy Guidelines for the CEP. At this time, staff estimated first year commitments to reach $1 billion with a target fee income of $3.5 million.
- August 2004: The Governor signed Legislation clarifying CalPERS' ability to provide credit enhancement to municipalities.
- December 2004: CalPERS received AAA long-term ratings from both Moody's Investor Services and Fitch Ratings.
- February 2005: Staff booked the first CEP transaction through a participation agreement with Bank of New York (BONY).

Program Summary and Statistics:

Staff underwrote $642 million in commitments from February 2005 through December 2005 generating fee income of $935,000. A majority of the initial transactions in the CEP portfolio were inherited from BONY through participation agreements. The CEP portfolio commitments and earnings are detailed in Table 1 on the following page.

Table 1. Commitment and Fee Income Earned

Security Description		Commitment	Commitment Date		Pro-rated Net Fee (inception to 12/31/05)
Michigan State Building Authority	$	100,000,000	2/3/2005	$	153,785
California General Obligation Bonds		75,000,000	3/15/2005		147,769
California Dept of Water Res B-3*		75,000,000	4/13/2005		187,310
California Dept of Water Res F-3*		75,000,000	12/1/2005		14,361
California Infrastructure Bank Bay Bridge		53,698,630	6/20/2005		34,193
Vermont Student Assistance Corp		63,892,602	7/20/2005		33,184
New York City General Obligation		100,000,000	5/6/2005		291,052
New York City Transitional Finance Authority		100,000,000	3/15/2005		73,511
Total	**$**	**642,591,232**		**$**	**935,166**

*These two deals are the same issuer

As of December 31, 2005, CalPERS' CEP portfolio consisted of eight deals with exposure to seven issuers across five sectors (see chart 1 and 2 below).

Chart 1. State Geographic Distribution

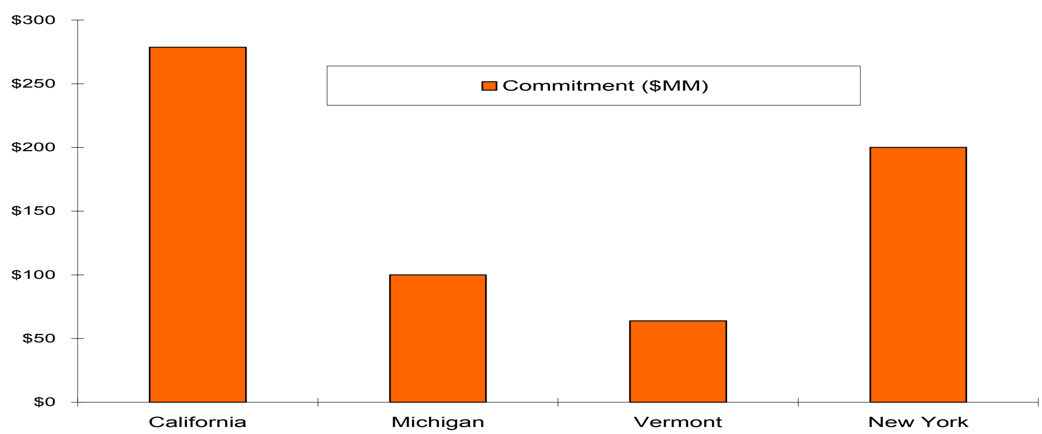
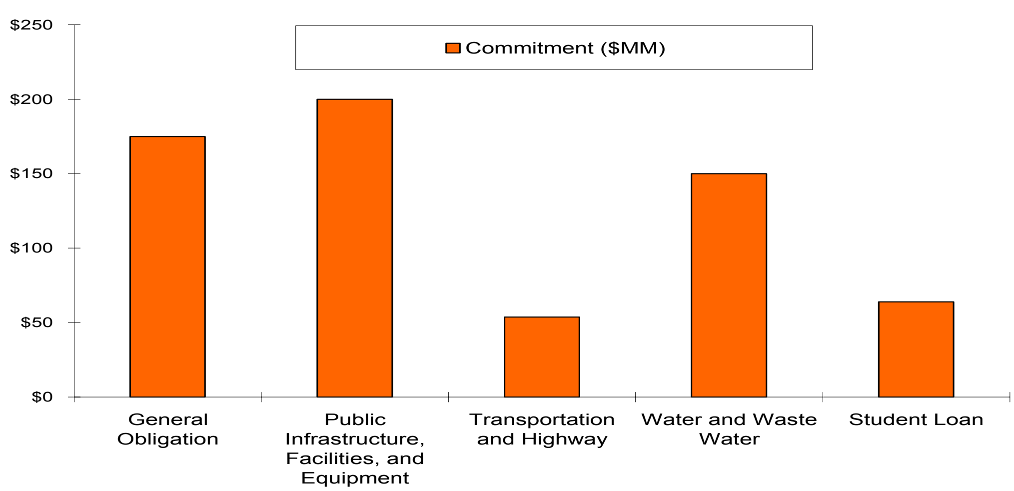


Chart 2. Municipal Sector Distribution



Discussion:

At the September 2003 Investment Committee Meeting, staff estimated the first year commitment levels would approach $1 billion and generate fee income of $3.5 million. Staff did not meet either the underwriting or earnings targets due to the following reasons:

i.) New Entrants – New credit providers entered the market over the past 18-24 months, including but not limited to Fortis, Citibank, and Depfa. These banks used aggressive pricing in order to build a revenue base and to establish a presence within the market.

ii.) Rating Change of German Banks – In 2005, the Landesbanks lost their sovereign status which resulted in a downgrade from AAA to A. Before the downgrades took affect, the Landesbanks aggressively priced Letters of credit to their existing clients while extending the tenor of those commitments.

iii.) Improving Credit Quality of Municipal Market – Key credits, such as the State of California, improved in their financial condition during 2005 resulting in lower enhancement spreads.

Due to the aggressive pricing conditions within the market over the last 18 months, staff and our partner BONY chose to underwrite fewer transactions and commit less capital to the market while maintaining a disciplined approach to those deals in which we participated. Staff is currently exploring a variety of initiatives that are expected to add value to the program over the next 6 to 12 months.

V. STRATEGIC PLAN:

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS:

The Credit Enhancement Program generated fee income of $935,000 for the year ending December 31, 2005.

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